



June 2006

Legislative Audit Division

State of Montana

Report to the Legislature

Performance Audit

Improving Taxpayer Compliance in Montana Through Audit Efforts

Department of Revenue
Business and Income Taxes Division

This audit report concludes taxpayer noncompliance for individual income and corporate license taxes results in underpaid taxes in Montana. In order to improve taxpayer compliance, the department needs to develop a plan of action that includes:

- Strategic planning to focus efforts.
- Performance measures to guide actions.
- Montana specific tax gap analysis.
- Strengthening audit function.

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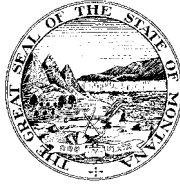
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June 2006

The Legislative Audit Committee
of the Montana State Legislature:

The Department of Revenue has an important role in facilitating taxpayer compliance and ensuring citizens and businesses pay the correct amount of tax. Key in this regard is the department's compliance audit function. The Legislative Audit Committee directed this office to conduct a performance audit of the department's compliance audit function for individual income, corporate license, and natural resource taxes.

Recent estimates show there are significant taxpayer compliance problems with two of the largest taxes – individual income and corporate license. In order to improve taxpayer compliance, we make recommendations to the department to strengthen its audit function. Our recommendations are to prioritize audit efforts through long-term strategic planning, develop performance measures to guide audit efforts, and conduct regular tax gap analysis to measure taxpayer compliance with Montana's tax laws. Additional recommendations are to more effectively target compliance work, conduct an audit staffing analysis, and expand use of data matching to better identify taxpayer noncompliance.

We wish to express our appreciation to Department of Revenue officials and staff for their cooperation and assistance throughout the audit.

Respectfully submitted,

/s/ Scott A. Seacat

Scott A. Seacat
Legislative Auditor

Legislative Audit Division

Performance Audit

Improving Taxpayer Compliance in Montana Through Audit Efforts

**Department of Revenue
Business and Income Taxes Division**

Members of the audit staff involved in this audit were Lisa Blanford,
Steve Erb, and Angie Grove.

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Introduction

The Department of Revenue (DOR) administers Montana's tax laws and serves as the general tax collection agency. Revenue collection responsibilities necessitate appraising values of taxable property, assessing tax liability, and auditing for taxpayer compliance. Three of the main revenue components of the state's General Fund are individual income, corporate license, and natural resource taxes. In fiscal year 2005, the state's General Fund collected more than \$1.46 billion of which 60 percent was from these component taxes. The department's compliance audit efforts resulted in collections of \$45.8 million including penalties and interest.

The Legislative Audit Committee requested a performance audit of DOR's compliance audit function for individual income, corporate license, and natural resource taxes. We examined audit activities from 2002 through the present.

Background

Audit is one of the tools used by the department to support its compliance function. All audit activities are consolidated in the Business and Income Taxes Division (BITD). This division is responsible for ensuring compliance with tax laws. DOR's audit staff are located in Helena and in several of the state's larger cities. Staff perform both office audits and field audits. Field audits involve travel to corporate or business headquarters.

Estimating Taxpayer Compliance

Under a voluntary system of taxation, citizens compute, report, and remit taxes due at the time and in the manner set by state and federal tax laws. Each year a difference arises between what taxpayers should pay and what they actually pay. This difference is referred to as the "tax gap" and is a recognized measure of taxpayer compliance. The tax gap occurs at both the federal and state levels. Periodically, federal and state taxing agencies estimate the size of their tax gap.

Taxpayer Noncompliance in Montana

Montana's 2005 estimated underpaid taxes are \$145-195 million for individual income and \$33-45 million for corporate license taxes. The overall noncompliance rate is 18-22 percent for individual income and 26-33 percent for corporate license tax, which reflects percent of dollars misreported. DOR's tax gap estimates are a net

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gap and represent underreported taxes remaining after the department's audit function recovers some of the gap. DOR estimates include the following key findings:

- ▶ Taxpayer noncompliance with individual income and corporate license tax laws results in significant underpayment of taxes in Montana.
- ▶ Taxpayer noncompliance is increasing in Montana with the individual income tax gap increasing between 1992 and 2005.
- ▶ Montana's individual income tax gap (18-22%) is higher than other states we reviewed. Specifically, Minnesota and California estimate their individual income tax noncompliance rate at 11 percent.
- ▶ For corporate license tax, the estimated percentage of tax gap is higher for Montana (26-33%) than for the nation as a whole (12%).

It is apparent Montana's taxpayer noncompliance is significant. DOR needs to develop a plan to reduce the tax gap and improve taxpayer compliance.

Long-Term Planning Needs to be Done

DOR needs to complete a strategic planning effort to help focus its audit activities. Current audit activities are not focused on achieving quantifiable results tied to the department's goals or objectives. The lack of long-term planning has resulted in the department initiating a number of audit activities without a coherent strategy. Long-term planning can focus audit activities on reducing taxpayer noncompliance and will allow the department to prioritize its efforts, identify performance expectations, measure results, and determine when goals and objectives have been achieved. Long-term planning will help the department realign its resources in the face of emerging requirements without losing focus on its overall mission. We make recommendations for the department to complete a strategic planning effort to focus its audit activities on reducing taxpayer noncompliance and establish priorities to achieve audit goals and objectives.

Using Performance Measures

A primary component of any long-term planning process is the establishment of performance measures to gauge achievement of goals and objectives. We found the department's audit activities generally lack a means of determining their overall effectiveness. If the department were to develop performance measures to compare to initial expectations, it could make data-driven, results-oriented decisions about whether to continue or eliminate specific activities. We make recommendations for the department to identify performance goals and collect performance data for audit activities to determine their effectiveness.

Tax Gap Analysis is a Tool for the Department

A tax gap will always exist but the data derived from analysis of the gap can be a tool for administration of the audit function. Results of tax gap studies can be incorporated into DOR decision-making. Regular tax gap studies can become key to the department's activities to improve taxpayer compliance and form a foundation for the department's efforts in establishing goals, objectives, and priorities. The department has not regularly conducted tax gap studies or used previous results as a means of measuring the effectiveness of its policies or activities. We make recommendations to the department to conduct regular tax gap studies to measure compliance with Montana's tax laws and provide the results to the legislature.

Strengthening the Compliance Audit Function

Multiple studies have shown one key to improved taxpayer compliance is a strong enforcement program. Audits are one activity that has a statistically significant impact on taxpayer compliance and are among the compliance activities with the largest indirect effect relative to their cost. While there are other components for improving taxpayer compliance such as simplicity of tax laws and forms, taxpayer education, improved disclosure of tax-related information and pre-paying taxes due through withholding – tax enforcement programs are a proven key component. We make recommendations for the department to strengthen its compliance audit function by directing audit activities to achieve the greatest benefit. We also make recommendations relating to the use of audit

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staff and enhancing data matching capabilities to identify taxpayer noncompliance.

Chapter I – Introduction

Introduction

The Legislative Audit Committee requested a performance audit of the Department of Revenue's compliance audit functions. The Department of Revenue (DOR) administers Montana's tax laws and serves as the general tax collection agency. Revenue collection responsibilities necessitate appraising values of taxable property, assessing tax liability, and auditing for taxpayer compliance. Three of the main revenue components of the state's General Fund are individual income, corporate license, and natural resource taxes. In 2005, the state's General Fund revenues exceeded \$1.46 billion. More than \$880.9 million of this total was from these component taxes of which \$35.0 million and \$10.8 million was due to DOR's audit efforts and penalties and interest respectively.

Audit Objectives

The objectives of this audit focused on the department's compliance audit function for individual income, corporate license and natural resource taxes. The objectives are to answer the following questions:

- ▶ If the audit function is focused to meet the department's stated goals and mission?
- ▶ If there are established performance measures and if those measures are reasonable?
- ▶ If information resources and analysis efforts (i.e., audit results, tax gap analysis, internal analysis of risks, etc.) are used to reevaluate policies and organizational goals?
- ▶ If audit staff resources are aligned to maximize effectiveness of audit efforts?

Scope and Methodologies

To address the audit objectives, we reviewed state laws, legislative reports, and Department of Revenue publications that describe the state tax system and compliance programs. In addition, we interviewed department staff, including Business and Income Taxes Division, Information Processing and Technology Division, legal services, Tax Policy and Research, human resources and the executive office. We gathered information from the Internal Revenue Service and other states' tax entities for comparison purposes.

Chapter I – Introduction

To evaluate department efforts to identify and audit taxpayer compliance, we interviewed department staff about compliance plans, audit selection procedures, and audit results. We also examined tax gap studies and analyzed summary data on audit results and audit program expenditures. We analyzed available production data for individual income, corporate license, and natural resource taxes to assess the relative productivity of various types of audits. We examined audit activities from 2002 through the present.

Because the audit focused on the department's compliance audit function, we did not include several aspects of tax compliance efforts. For example, we did not assess the department's criminal investigation function; analyze use of education, incentives and penalties; assess effectiveness of the department's existing legal tools to access taxpayer information; or examine department efforts to collect taxes due.

By law, certain aspects of tax auditing such as audit selection criteria, are protected, nonpublic data. As a result, we will not report some of our evaluation results in detail.

Areas for Future Performance Audit

As noted above, there are other functions that play a key role in promoting voluntary taxpayer compliance. Some of these areas may benefit from future performance audits. They include:

Tax Collections

States have struggled with the issue of taxpayers who file returns with a balance due or who owe taxes after an audit, but do not pay. This tax debt can be significant. As of May 23, 2006, the department reports \$53 million in receivables (accounts receivables balance). A performance audit could examine how successful the department is in collecting delinquent tax payments. Audit work could assess the debt portfolio and examine effectiveness of DOR's tax accounts receivable function, including debt collection practices and tools available to collect obligations from taxpayers, including taxpayer bankruptcy proceedings.

Third Party Disclosure and Withholding Requirements

Third party disclosure and tax withholding are tools for effective administration of tax systems. When taxes are actually withheld at the point of payment (such as with wages) the amount of compliance is high and chances are good the taxpayer will file a return with the amount of income accurately stated. Similarly, when income information is reported by a third party, there is a lower risk of noncompliance by taxpayers.

The department states a significant portion of taxpayer income is not subject to third party disclosure and withholding requirements. A performance audit could examine Montana's disclosure and reporting requirements and contrast them to other states and the federal government and issue recommendations to strengthen these requirements if needed.

Chapter II – Background

Department of Revenue

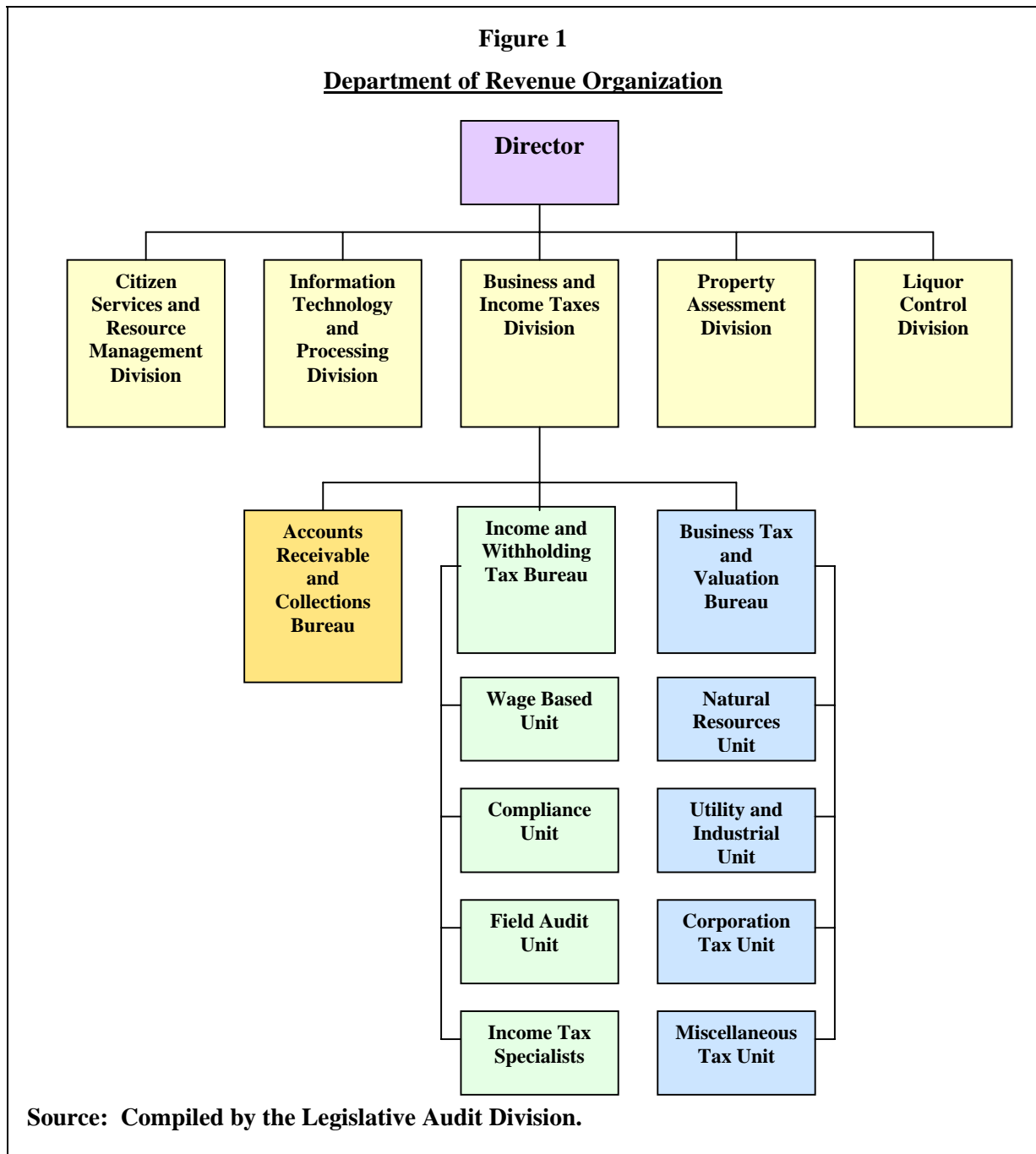
The Department of Revenue (DOR) recently underwent a reorganization that consolidated all tax collections under the umbrella of the Business and Income Taxes Division (BITD). Under BITD, there are three bureaus associated with collecting taxes: Accounts Receivable and Collections Bureau, Income and Withholding Tax Bureau, and Business Tax and Valuation Bureau.

Income and Withholding Tax Bureau

The Income and Withholding Tax Bureau is responsible for ensuring compliance with tax laws for individual income taxes – including personal income and certain business. There are two types of businesses who file their taxes via individual income taxes: sole proprietorships and pass through entities. Pass-through entities include S-corporations, partnerships, and limited liability corporations. This bureau is also responsible for ensuring compliance with wage-based income tax requirements. Bureau staff includes wage-base auditors, Helena-based income tax auditors and income tax field auditors. Field auditors are located throughout the state, primarily in the state's larger cities.

Business Tax and Valuation Bureau

The Business Tax and Valuation Bureau is responsible for ensuring compliance with natural resource tax laws for businesses involved in extracting natural resources within the state. This bureau is also responsible for ensuring businesses comply with corporate license tax laws. This tax is paid by C-corporations that are generally larger corporations and often involve multi-state and multi-national corporations. Audit staff in this bureau perform both Helena-based office audits and field audits. Field audits often involve out of state travel to corporate headquarters. This bureau is also responsible for utility and industrial property valuations and a variety of other miscellaneous taxes. The following figure describes the basic structure of the department with additional detail provided to describe BITD.



Tax Revenues

The department is responsible for the vast majority of revenues collected by the state. In 2005, the department's income-related and miscellaneous tax revenues were over \$1.12 billion to the General Fund. Nearly \$932 million of General Fund revenues were collected

Chapter II – Background

from individual income taxes, corporate licensing taxes, and natural resource related taxes. The table below provides a breakdown of tax revenues.

Table 1
State Tax Revenues
Fiscal Years 2001 through 2005

	2001	2002	2003	2004	2005
Individual Income Tax	\$556,014,554	\$517,567,691	\$535,830,664	\$605,348,421	\$712,280,615
Natural Resource Tax ⁽¹⁾	70,730,347	54,416,565	68,599,590	86,079,486	121,895,529
Corporate License Tax	103,670,487	68,173,254	44,137,518	67,722,940	98,213,717
Other Miscellaneous Taxes ⁽²⁾	<u>116,492,101</u>	<u>112,238,392</u>	<u>120,856,708</u>	<u>174,401,220</u>	<u>189,817,667</u>
Total	\$ 846,907,489	\$752,395,902	\$769,424,480	\$933,552,067	\$1,122,207,528

⁽¹⁾ Includes coal severance, oil and gas production, resource indemnity trust, and metalliferous mines taxes.

⁽²⁾ Includes liquor, cigarette, lodging, telecommunications, inheritance, and miscellaneous taxes.

Source: Compiled by the Legislative Audit Division from Department of Revenue data.

Audit Revenues

In fiscal year 2005, the department's compliance audit efforts resulted in collections of \$45.8 million including penalties and interest. The department selects a number of returns for audit subject to the statutes of limitations associated with each type of return. Revenue from audits are posted in the current year, but could be from audit work performed or returns filed in prior years. Additional penalties and interest can be assessed based on DOR audit efforts. In addition, if a taxpayer underpays their tax liability they may "self-assess" penalties and interest when they submit a tax return to DOR. While revenues from audits of individual income tax returns have increased, revenues from corporate license and natural resource audits have decreased recently.

Returns Filed

Revenues are generated from the returns of Montana taxpayers. The table below identifies the number of Montana returns processed for individual income, corporate license, and natural resources taxes.

Table 2
Number of Montana Tax Returns Filed

Tax Types	Number of Returns
Individual Income Tax	
Individual and Partnership ⁽¹⁾	473,749
S-Corporations ⁽²⁾	<u>19,328</u>
Total	493,077
Corporate License Tax ⁽²⁾	16,297
Natural Resource Taxes ^{(2) (3)}	
Coal Tax Producers	5
Combined Oil & Gas Producers	300
Metal Mines	5
⁽¹⁾ Calendar year 2003. ⁽²⁾ Fiscal year 2004. ⁽³⁾ Natural resource producers submit taxes quarterly. Numbers in table are number of returns in a single quarter.	

Source: Compiled by the Legislative Audit Division from Department of Revenue 2004 Biennial Report.

Audits Improve Taxpayer Compliance

Multiple studies have shown one key to improved taxpayer compliance is a strong enforcement program. Audits are one activity that has a statistically significant impact on compliance and are among the activities with the largest indirect effect relative to their cost. The indirect effect of audit is 11.7 times as large as the average adjustment directly assessed by audit. A study of federal tax compliance performed by the California Institute of Technology concluded reduced audit emphasis from a 2.5 percent coverage level to 1.1 percent over a ten year period produced a “huge reduction” in compliance, even during a period when tax rates were reduced. This study estimated if original audit coverage rates had been maintained, total federal revenue collected would have been significantly higher with 93 percent of the total resulting from the deterrent effect of a greater level of audit coverage. These studies support that an effective enforcement program is critical to taxpayer compliance.

DOR's Compliance Tools

The department has a number of available tools to support its compliance function. These include:

- ▶ Recommend tax legislation.
- ▶ Publish forms, instructions, and guidance.
- ▶ Assist and educate taxpayers.
- ▶ Administer tax withholding and third party reporting.
- ▶ Capture return data and process payments.
- ▶ Resolve processing exceptions.
- ▶ Issue bills and resolve protests.
- ▶ Conduct audit functions and assess penalties and interest.
- ▶ Collect taxes due.
- ▶ Litigate.
- ▶ Initiate enforcement.
- ▶ Cross-matching data from other information sources.

Chapter III – Estimating Taxpayer Noncompliance

Introduction

Under a voluntary system of taxation citizens compute, report, and remit taxes due at the time and in the manner prescribed by state and federal tax laws. Each year a difference arises between what taxpayers should pay and what they actually pay. This difference is referred to as the “tax gap” and is a recognized measure of taxpayer compliance and noncompliance. The tax gap occurs at both the federal and state level. There are three primary contributors to the tax gap:

- ▶ Nonfiling (failing to file tax return).
- ▶ Underreporting (understating income or overstating deductions, exemptions and credits).
- ▶ Underpayment (failing to remit amount of tax due).

The primary source of tax gap analysis is the federal government. Many states, Montana included, derive their tax gap from the federal analysis. Tax gap analysis are estimates based on a random sample of audited tax returns and other information.

The key benefit of tax gap analysis is that by identifying areas of taxpayer compliance and noncompliance, areas of risk are also identified. This information can be used by both policy makers and the department to make informed decisions to ensure a fair and equitable tax system is maintained. By regularly measuring tax compliance, the results can be used to identify new or growing areas of noncompliance and make informed decisions about resource allocations to address noncompliance.

This chapter presents information on the:

- ▶ Significance of taxpayer noncompliance and its impacts.
- ▶ Estimated dollar amounts of underreported taxes.
- ▶ Factors that contribute to taxpayer noncompliance.
- ▶ Increasing taxpayer compliance.

Chapter III – Estimating Taxpayer Noncompliance

In addition, the following conclusion is made:

- ▶ There is a significant amount of underpaid taxes from individual income and corporate license taxes due to taxpayer noncompliance based on results of the tax gap analysis.

Significance of Taxpayer Noncompliance

The existence of tax gaps and taxpayer noncompliance pose significant challenges to tax administration. It represents an issue that not only has a direct impact on state finances but also an indirect effect on individual and business taxpayer behavior. According to the California Legislative Analyst's Office, larger tax gaps translate to:

- ▶ **Higher Tax Rates.** The existence of a substantial tax gap means that for government to raise any given level of revenue, it must impose higher tax rates or other fees on taxpayers. As a result, compliant taxpayers pay at rates higher than would otherwise prevail absent a tax gap.
- ▶ **Weakened Tax System.** If taxpayers perceive other individuals and businesses are not shouldering their share of the tax burden, they are likely to question their own need to fully comply with the tax laws. This can lead to increased taxpayer noncompliance.
- ▶ **Loss of Government Services.** The impact of a tax gap can be the loss of government services due to budgetary constraints.

Noncompliance of Montana Taxpayers

The Montana Department of Revenue (DOR) recently conducted a tax gap analysis for both individual income and corporate license taxes based on the IRS analysis. According to data released in 2005, Montana's estimated tax gap is \$145-195 million for individual income and \$33-45 million for corporate license taxes for fiscal year 2005. The overall noncompliance rate is estimated at 18-22 percent for individual income and 26-33 percent for corporate license tax, which reflects percent of dollars misreported. Montana's individual income noncompliance rate is much higher than the 11 percent rate that exists in Minnesota and California. It is difficult to compare Montana's corporate noncompliance rate to other states or the federal government because of differences in tax policies or outdated information. DOR's tax gap estimates are a net gap and represent

Chapter III – Estimating Taxpayer Noncompliance

underpaid taxes remaining after the department's audit function recovers some of the gap.

Since DOR's tax gap estimates do not include two of three components - revenue losses from non-filing or underpayment - the estimated tax gap for Montana is likely understated.

The rate of taxpayer noncompliance varies depending on the type of income and adjustments, deductions, and exemptions that offset income. For example, the noncompliance rate for wage earners is 1.2 percent – meaning 1.2 percent of wages are misreported for tax purposes. The noncompliance rate for partnership income is 11.1 percent and 62.2 percent for net business income.

Noncompliance is Increasing

Until the most recent tax gap analysis, Montana's last tax gap analysis was conducted in 1995 and based on 1992 tax returns. Montana's individual income tax gap actually increased between 1992 and 2005, even after adjusting for inflation. The state tax gap for individual income taxes was \$93.5 million in tax year 1992 and has increased to a current gap of \$145-195 million. Taking the 1992 tax gap and adjusting it for inflation yields an estimated tax gap of \$130 million in today's dollars.

Conclusion: Taxpayer noncompliance with individual income and corporate license tax laws results in underpaid of taxes in Montana.

Improving Taxpayer Compliance

Reducing the tax gap and improving taxpayer compliance is something both the federal and state governments are working to address. Research at both the federal and state level provides a number of strategies to improve taxpayer compliance and identify those areas where noncompliance is occurring. General strategies include such things as improved taxpayer education programs, simplifying tax regulations and forms, increasing third party reporting of income and deduction information, additional withholding of tax, and increasing audit activities. Federal government efforts to address the tax gap include the following:

Chapter III – Estimating Taxpayer Noncompliance

- ▶ **Refocus and Adjust Audit Process.** Shift audit resources to likely areas of tax noncompliance and reduce the audit cycle for certain types of taxpayers. Improve measurement and detection of noncompliance by leveraging the enforcement and data gathering activities of other agencies.
- ▶ **Detect and Deter Tax Evasion.** Strengthen efforts to detect this activity and pursue criminal action against taxpayers using such tactics. Efforts normally focus on corporations and high-income individuals.
- ▶ **Deter Abuse by Tax Exempt Entities.** Target audits to particular areas of this sector engaged in abusive tax activities in order to deter noncompliance.

Other specific gap reduction strategies include:

- ▶ Target areas of greatest risk as identified in gap analysis.
- ▶ Direct audit resources to areas of noncompliance that result in highest net return.
- ▶ Target certain credits and deductions that are most susceptible to abuse.
- ▶ Use data from the IRS and other state agencies to identify nonfilers.
- ▶ Enhance detection of preparers filing fraudulent returns.
- ▶ Institute an informant reward program.
- ▶ Provide resources and support for criminal investigations.
- ▶ Focus on form 1099 filings for independent contractors.
- ▶ Establish taxpayer ID verification systems to improve accuracy of reported income information.

Improving Compliance Will Increase Montana Revenue to the General Fund

According to a U.S. Government Accountability Office (GAO) study, closing the entire tax gap may not be feasible since it could entail more intrusive recordkeeping or reporting than the public is willing to accept, or more resources than the government is able to commit. Some portion of the tax gap will always exist. However, given the size of the tax gap in Montana even modest reductions would yield very significant financial benefits. The following table presents estimates of additional taxes the state could collect by

Chapter III – Estimating Taxpayer Noncompliance

reducing the tax gap for individual income and corporate license taxes.

Table 3

Annual Montana Taxes Potentially Collectible by Reducing Tax Gap

Percent Tax Gap Reduction	Additional Individual Income Tax Revenue ⁽¹⁾	Additional Corporate License Tax Revenue ⁽²⁾
5 percent	\$7.25 - 9.75 million	\$1.65 - 2.25 million
10 percent	\$14.5 - 19.5 million	\$3.3 - 4.5 million
15 percent	\$21.75 - 29.25 million	\$4.95 - 6.75 million

⁽¹⁾ Calculation based on a net tax gap estimated at \$145 - 195 million.

⁽²⁾ Calculation based on a net tax gap estimated at \$33 - 45 million.

Source: Compiled by the Legislative Audit Division based on Department of Revenue 2005 tax gap estimates.

In 1996, the IRS estimated 30 percent of the federal gross income tax gap is collectible. Gross tax gap is equal to net tax gap plus collections from audit. Using this as a benchmark, Montana could collect an additional \$17.5 to \$32.2 million in individual income tax and \$2.5 to \$6.1 million in corporate license tax. These numbers are different than those listed in Table 3 because Table 3 is based on net audit collections. Montana may be able to improve on this figure given their access to local information.

Chapter IV – Improving Montana Taxpayers’ Compliance

Introduction

From the previous discussion, it is apparent Montana’s taxpayer noncompliance is significant. Department of Revenue (DOR) needs to develop a plan to reduce the tax gap and improve taxpayer compliance. This chapter addresses organizational initiatives the department can take to strengthen specific aspects of the department’s compliance audit function. These include: strategic planning to focus efforts, performance measures to guide actions, and the need for more frequent and regular tax gap analyses to measure taxpayer compliance with Montana’s laws.

Strategic Planning Can Focus Efforts to Improve Taxpayer Compliance

Managers need to conduct a thorough analysis of their organizational mission and respond to changes in operational/political environments and focus available resources to accomplish key requirements. An effective way of conducting this type of analysis is through strategic planning. Some key aspects of strategic plans are:

- ▶ Outlining long-range scope, at least five-years.
- ▶ Developing quantifiable and measurable goals and objectives.
- ▶ Identifying what resources are needed to complete the goals and objectives.
- ▶ Identifying key factors beyond the control of the agency which could affect meeting its goals and objectives.
- ▶ Determining how goals and objectives would be accomplished by developing a performance action plan.
- ▶ Identifying an evaluation process to establish or review the goals and objectives.

Organizational Changes at DOR have Affected Audit Activities

DOR has undergone substantial changes in the past decade. Several reorganizations, the replacement of organization-wide information systems, and significant changes in resource allocations have disrupted the department’s central processes and undermined efforts to accomplish basic missions. Department managers are aware this turmoil had a negative effect on its audit activities.

Chapter IV – Improving Montana Taxpayers’ Compliance

The department has undertaken a number of efforts to reinvigorate its tax compliance efforts. The department recently completed an analysis of the federal tax gap conducted by the Internal Revenue Service (IRS) to determine Montana’s tax gap. The department developed goals and objectives. The department is in the final stages of implementing a transition to a new central computer system that should allow for more effective compliance activities. It has established a compliance team, which includes managers from in and out of the Business and Income Taxes Division (BITD). The compliance team meets weekly to coordinate departmental efforts to increase tax compliance rates. Associated with the compliance team is the compliance team work plan. BITD has also begun work on a draft compliance plan, which is envisioned to guide the division’s audit activities.

DOR Has Not Completed a Strategic Planning Effort

While the department is undertaking activities to improve its audit function, it has not completed strategic planning, either at the department or division level, to focus its efforts. There has been so much change in the department’s key management positions the organization lacked the continuity necessary to complete the task. During this period of continual change, the department agrees it lost focus on some of its critical functions and was overwhelmed by other events.

The Department Needs to Focus its Activities

The department recognizes it has lost focus on its taxpayer compliance related activities in the past for many reasons. Current management appears to have reinvigorated the staff of BITD and there is a general feeling the department is moving forward. However, the department now needs to complete a coherent data-driven, and prioritized plan to accomplish its objectives. We recognize the department undergoes cyclic high tempo operations that can have a significant effect on the activities of the department and can make conducting long-range planning difficult. However, for this very reason, the department must create goals and objectives that align its resources and focus its efforts throughout these events and keep the organization on a path to mission accomplishment.

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The department’s audit activities have been described as exploratory with no identified performance goals associated with them. The department has also stated all these exploratory efforts must be completed before any long-range planning can be completed or performance goals can be established. The lack of performance goals or measures associated with audit activities prevents BITD from determining whether audit activities are meeting the department’s goals or objectives in any quantifiable way. The department’s existing goals and objectives do not orient audit efforts toward accomplishing critical activities at the BITD level. The lack of ordered priorities for the department’s audit activities results in work continually being reprioritized and preventing a coherent strategy from emerging.

Symptomatic of this condition is the compliance team work plan and the BITD compliance draft plan. The compliance team work plan is a collection of activities the department has identified as necessary for increased taxpayer compliance with existing laws. However, the work plan does not set ordered priorities for completing activities. Similarly, the BITD compliance draft plan is envisioned as the division’s plan for accomplishing the department’s goals and objectives associated with tax collections and audit activities. However, because of competing priorities, it continues to be an incomplete draft. Failure to complete the compliance plan hinders managers from achieving results consistent with DOR’s highest priorities.

A strategic planning-type effort focusing on reducing the tax gap, establishing measurable goals and objectives, setting priorities to achieve these goals, aligning resources to achieve goals, and establishing performance expectations to allow managers to determine and maximize program effectiveness is needed. The department should reevaluate its existing audit activities to determine if they continue to meet the department’s audit needs and then prioritize its activities, set performance goals for existing and future compliance activities, and measure the results of compliance

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activities to allow managers to make decisions on compliance activities based upon the pre-established performance goals.

Recommendation #1

We recommend the Department of Revenue:

- A. Complete strategic planning for its audit activities to focus efforts on reducing taxpayer noncompliance.**
- B. Establish priorities for achieving audit goals and objectives.**
- C. Expedite completion of the Business and Income Taxes Division compliance plan.**

Performance Measures

One of the basic requirements of any goal or objective is that it be measurable. If a goal or objective is not measurable, there is no way for an organization to determine if its activities are having any positive effect. A cornerstone of determining the effectiveness of any activity is to be able to determine what the desired performance should be, collect data to measure actual performance, and then compare those two values.

Existing Performance Measures Need to be More Specific to Audit Activities and Address Departmental Goals and Objectives

The department currently has only two performance measures associated with its audit activities. These performance measures are output measures and do not relate to achieving either the department’s goals and objectives or increasing taxpayer compliance. Current performance goals allow for annual revenue projections in the governor’s budget or to justify specific personnel increases. The department does not use these performance measures to set policy or modify activities.

The first performance measure is the annual audit revenue expectation the department provides to the Governor’s Office of Budget and Program Planning and the Legislative Fiscal Division for revenue estimating and developing the state’s operating budget. This measure is not a performance goal it is a budget goal.

The second audit-related performance measure involves revenue collections from new FTEs authorized by the 2005 legislature. The

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department is in the midst of a major effort to reemphasize audit activities and increase taxpayer compliance. To target specific areas of noncompliance, the department received authorization for eight additional FTE to conduct compliance related activities in four defined areas. To justify these positions, the department developed a revenue collection goal for these new personnel of \$1.1 and \$2.3 million in fiscal years 2006 and 2007 respectively. The legislature approved the additional FTE with the stipulation the positions collect the additional revenues identified by the department.

BITD is using these additional positions to conduct a number of exploratory compliance initiatives. For example, reviewing property sales by nonresidents to see if tax obligations are being met. The initiatives were chosen because of experiences that occurred in other states. To meet its legislative obligation, BITD is monitoring the collections of the new positions to verify they are able to collect the revenues promised. BITD has not established any performance goals and measures that would assist managers in making decisions regarding the effectiveness of these initiatives. The only performance measures the division is collecting establishes a tie to personnel performance, rather than effectiveness of the compliance initiatives themselves.

Existing Performance Measures Are Not Useful

The department has collected limited performance data and set few performance goals for its audit activities. Without data, department managers are not able to effectively identify activities not meeting audit objectives to produce additional revenues and/or increasing taxpayer compliance rates.

We requested productivity information from the department for different audit efforts within each tax type (individual income, corporate license, and natural resources). This information was related to dollars of revenue for each dollar spent. While the department has data on overall productivity of audit (total cost of audit versus total collections from audit) it does not have productivity data on specific components of audit efforts such as office audit, field audit, or IRIS audit edits. When we reviewed other

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states’ audit activities, all gathered this type of information. For instance, in 2005 Minnesota’s audit productivity ranged from \$2.97 to \$13.92 in audit assessments for each \$1 spent on audit. The average for all income tax audits was \$6.71 per \$1 spent. California requires all compliance activities to return at least \$5 for every \$1 spent.

The department conducts a number of compliance initiatives with new staff, approved in the 2005 legislative session, targeting specific areas of potential taxpayer noncompliance. These initiatives began as information gathering efforts without identifying either comparison performance goals or how decisions would be made to continue the efforts. No performance goals were subsequently established to identify whether these initiatives were most effective. Without data related to the cost of conducting the initiatives, the department cannot determine if the costs outweigh the increased collections.

For example, one initiative involves identifying taxpayers who have not filed their taxes even though an electronic W-2 was provided to the state for the taxpayer. Using DOR’s output data, we completed the following analysis. However without performance goals to compare our results to, we are unable to determine the initiative’s effectiveness. To date, DOR has received \$194,790 in additional revenue from the 662 additional returns that were filed due to DOR’s audit efforts. This results in \$294 extra revenue per return filed. But to acquire those 662 new returns, the department sent out 2,414 letters, which results in a return of \$81 per letter. BITD is conducting a similar initiative with W-2s submitted to the state on paper which are generating returns of only \$46 per letter sent; however, audit managers have indicated significantly more time is required to complete this work because of the manual data entry required. This additional work could increase costs to the point where it is no longer cost effective for the department to continue with this initiative.

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The lack of formal performance data does not necessarily indicate the department’s managers are not reviewing audit activities. At one time, divisional managers were beginning to gather data related to the division’s output in an effort to identify performance trends. However, that collection effort is sporadic. Conversations with audit managers revealed they frequently discuss audit activities with the department’s auditors to identify whether there are targets that are not producing results. However, when changes are made, they are not validated with data. This problem is not unique to Montana. Minnesota’s auditors stated that unproductive audit projects continue because their department of revenue does not have the necessary performance data to assess and improve audit efforts.

DOR Does Not Emphasize Useful Performance Measures

There are a number of factors that could explain why the department does not set performance goals or collect performance measures for its audit activities. The current audit-related performance measures collected by the department are output measures and easily achieved. Current department performance standards are not based on specific efforts to either reduce the tax gap or achieve departmental goals and objectives. Department managers do not require audit-related compliance activities to include performance goals or determine achievement of those goals as a condition of their approval or continuation.

Setting a Policy to Become More Data-Driven

For the department’s audit activities to be more effective, management should require audit activities to be data and results-oriented. Performance goals should be set for compliance activities currently underway and future activities should not be initiated before goals are established. These goals should identify departmental expectations for productivity, duration, and intended effect. After performance goals have been identified, managers must ensure performance data is collected and compared to goals to ensure audit activities are supporting the department’s critical goals and objectives.

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Recommendation #2

We recommend the Department of Revenue:

- A. Identify performance goals for existing and future compliance audit activities in the areas of productivity, duration, and intended effect.**
- B. Identify and collect performance data for each audit activity for comparison with performance goals.**

Using Tax Gap Analysis as a Tool to Help Address Noncompliance

A tax gap will always exist but the data derived from analysis of the gap can be a tool for administration of the audit function. Results of tax gap studies can be incorporated into DOR decision-making. Regular tax gap studies can become key to the department’s efforts to improve taxpayer compliance and form a foundation for the department’s efforts in establishing goals, objectives and priorities.

GAO and Other States Stress Need for Gap Analysis

In a 2005 report to the U.S. Senate Committee on Finance, the Government Accountability Office (GAO) recommended the IRS develop plans to periodically measure tax compliance with a focus on individual income tax underreporting. The GAO states by regularly measuring compliance, the IRS could update tax gap estimates and use the results to guide its compliance efforts. The GAO also states regularly measuring compliance can offer many benefits including:

- ▶ Help identify new or growing types of noncompliance.
- ▶ Identify changes in tax laws and regulations that may improve compliance.
- ▶ More effectively target examinations of tax returns.
- ▶ Understand the effectiveness of its programs to promote and enforce compliance.
- ▶ Determine its resource needs and allocations.

Other states are recognizing the importance of conducting tax gap analyses that are based on state data as opposed to federal compliance data and are taking steps to conduct analysis on a more

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regular basis. The states of Minnesota, Idaho, and New York are examples of such states.

Regular Analysis of Montana Taxpayer Compliance Not Done

Although DOR recently completed a tax gap analysis to measure the extent of compliance with individual income and corporate license tax laws, this is the first gap analysis the department has done since the last one was completed using data from 1992 returns. The department has not conducted regular gap analysis and calculations for Montana.

One of the reasons the department has not performed regular gap analysis is the department’s gap analysis is a derivative based study. Staff use the gap analysis conducted by the federal government as the basis for calculating Montana’s tax gap. There are two drawbacks to this. First, the IRS gap analysis measures taxpayer compliance with federal tax laws - it does not measure compliance with state tax laws; particularly as it relates to nonresidents and out of state companies. The second drawback is by waiting on the results of federal gap analysis to conduct our own analysis, long periods of time elapse. The GAO stated the longer the period between tax gap analyses, the less useful the information is. Although the IRS periodically estimates the tax gap for federal taxes, there have been long time delays between studies. While the most recent tax gap study was done in 2005, the IRS had not conducted a tax gap study since 1988.

Lack of Montana Specific Gap Analysis Has Many Impacts

The lack of regular tax gap analysis that specifically examines taxpayer compliance with Montana’s tax laws affects the department’s ability to:

- ▶ Identify areas of greatest noncompliance and therefore greatest risk.
- ▶ Discover weaknesses in compliance tools and take corrective action.
- ▶ Align resources to target compliance risk areas and.
- ▶ Implement a strategy to reduce Montana’s tax gap for individual income and corporate license taxes.

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DOR Needs to Regularly Measure Taxpayer Compliance to Determine Effectiveness of Actions

The longer the time between tax gap analysis, the less useful they become. Without current taxpayer compliance data, the department has limited capability to determine key areas of noncompliance to address and actions to take to maximize the use of its limited resources.

One of the department’s objectives is to further improve tax compliance “based on the cycle of continuing tax gap assessment and performance measurement.” The department should conduct a tax gap analysis that specifically measures compliance with Montana’s tax laws. Because current tax gap analyses have little information on the impacts of nonfiling and underpayment, including these areas in future gap analyses could provide significant benefits to the department. In addition, regular gap analysis would be beneficial to both the department and policymakers. Conducting tax gap analysis with a minimum frequency coincidental with an audit-related strategic planning cycle will benefit the department by regularly measuring previous compliance activities’ effectiveness and permitting DOR to consider changes in future planning cycles.

Because policymakers are stakeholders in ensuring “fair and equitable” taxation of citizens, tax gap estimates should be provided to the Legislature when completed. The department should also provide legislators with its recommendations for addressing the tax gap. Statutes state in part, DOR has authority to, “Formulate and recommend legislation for the better administration of fiscal laws so as to secure just and equal taxation and improvement in the system of taxation,” Section 15-1-203, MCA.

If the department uses an outside economic group to conduct the initial analysis and train department staff on gap analysis methods, initial cost estimates range from \$300,000 to \$400,000. This estimate is based on the cost to the state of Minnesota for a sales and use tax gap analysis. The monetary benefits that can be realized by using the results of a gap analysis to develop and implement an informed plan of action to improve compliance and reduce the tax gap should exceed the costs. For example, using information in

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Table 3, a 5 percent reduction in the tax gap could increase General Fund revenues by nearly \$9 million.

Recommendation #3

We recommend the Department of Revenue:

- A. Conduct tax gap analyses that specifically measure compliance with Montana’s tax laws at intervals that, at a minimum, correspond with strategic planning cycles in order to recognize a need to make corrections to compliance activities.**
- B. Report the results of tax gap estimates to the Legislature with recommendations to address the tax gap.**

Chapter V – Strengthening the Compliance Audit Function

Introduction

While there are other components to improving taxpayer compliance such as simplicity of tax laws and forms, taxpayer education, improved disclosure of tax-related information, and pre-paying taxes due through withholding – tax enforcement programs are a proven key component. This chapter addresses changes needed to strengthen the department's audit function by:

- ▶ Better targeting audit efforts.
- ▶ Maximizing use of staff.
- ▶ Enhancing data matching capabilities to identify taxpayer noncompliance.

Audit Efforts Could be More Effective

Department of Revenue's (DOR) audit function provides a means for the department to examine taxpayers' financial records to determine whether they have accurately calculated and reported their tax liabilities. During this process, tax auditors examine and analyze taxpayer returns and records. If they discover underreported tax liabilities, they assess and collect taxes owed. In fiscal year 2005, department auditors collected \$45.8 million in individual, corporate license and natural resource taxes. Despite the department's audit efforts, taxpayer noncompliance resulted in an estimated \$178 - 240 million of unpaid taxes in fiscal year 2005. In addition, audit collections from corporate license and natural resource taxes have declined in recent years in part due to reduced audit focus.

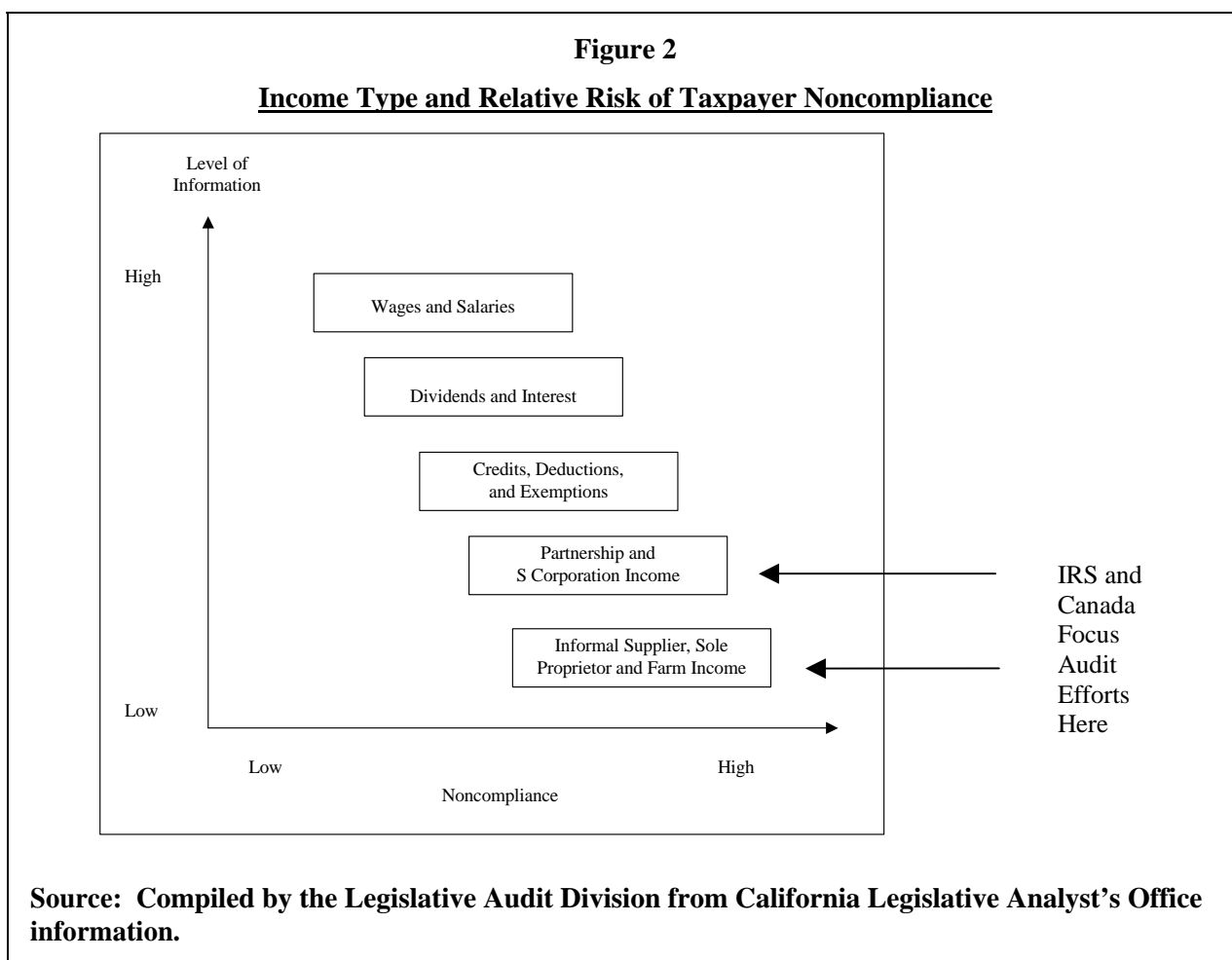
IRS, Canada, and States Focus Audit Efforts on Areas of Largest Noncompliance

In general, other tax compliance entities including the Internal Revenue Service (IRS), the Canadian Revenue Agency, and other states target audits in a manner that focuses on areas of greatest noncompliance, maximizes use of audit resources, produces a higher net rate of return, and improves taxpayer compliance. The IRS is shifting audit resources to likely areas of tax noncompliance as identified in the tax gap analysis and reducing the audit cycle for certain types of taxpayers; results of the effort are unknown at this time. The Canada Revenue Agency uses the same strategy of targeting areas of highest noncompliance. Their policy states wage

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and salary earners, where withholding and third party reporting is high, present relatively few compliance problems, thus the agency's audit program is directed mainly at those individuals deriving income from businesses and professions, as well as corporations and trusts.

Both the U.S. and Canadian governments estimate 70 percent of the current income tax gaps are due to underreporting of non-wage income (partnerships, proprietorships, S-corporations, rent, royalties, estates, trusts and farms). As a result, both governments are targeting these areas. The following figure illustrates the relationship between type of income and risk of taxpayer noncompliance.



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DOR is Not Targeting Identified Contributors to the Tax Gap

The department needs to shift existing resources to areas that have the potential to be more productive at eliminating the known tax gap, collecting additional underreported income, and maximizing the department's net rate of return. Exploratory efforts into other potential areas of noncompliance should continue to be done at a lower priority until better data is developed to justify the use of limited resources. Similarly, audit efforts should be tempered by targeting those areas where the department has the highest potential for collecting revenues with its existing tools.

The department's current efforts are not targeting those areas of greatest noncompliance as identified in the tax gap analysis. While the tax gap is limited in its ability to identify lost revenues due to noncompliance by nonresidents, it still identifies \$145 – 195 million unpaid by Montanans on their individual income taxes and \$33-45 million not being paid by Montana C-corporations.

Department Could Better Target Audit Efforts

Historically, DOR's compliance audit enforcement activities have generated more revenues for the state than their operating costs. However, the department could collect more of the existing taxes due if it used existing audit resources more efficiently and effectively. The department needs to shift existing resources to areas that have the potential to be more productive in terms of reducing the tax gap, collecting additional underreported income, reducing inequities in filing rates, and maximizing the department's net rate of return. In addition, the department should focus compliance and enforcement efforts on those areas where DOR has the greatest probability of collecting taxes owed due to stronger legal authority. Once the department undertakes steps needed to strengthen its legal authority to collect taxes due from nonresidents, compliance efforts will be more successful in this area. By implementing these recommendations, the department could more effectively tailor its efforts to improve taxpayer compliance. In addition, these changes would help to ensure the department uses their staff resources in the most efficient and effective manner.

Recommendation #4

We recommend the Department of Revenue:

A. More effectively deploy audit resources by directing audit activities to focus on the following factors to achieve the greatest benefit:

- **Areas of greatest taxpayer noncompliance as identified in the tax gap.**
- **Opportunity to generate the highest net returns.**
- **Areas with the strongest legal enforcement and collection tools.**
- **Opportunities to provide staff training.**
- **Opportunities to reduce inequities in filing rates among major tax filing groups.**

B. Conduct an analysis of the department's existing legal, enforcement, and collection tools to improve the department's ability to secure tax compliance from nonresidents.

Issues Limiting Effective Use of Audit Staff

One of the major roles of management is to plan and direct organizational activities to maximize the use of limited resources. The department is not maximizing the use of compliance audit staff. There are a number of issues affecting staffing within the Business and Income Tax Division. Current staffing levels for the different tax types are based on historical levels and may not provide the best levels needed to address current areas of noncompliance. Changes in staff responsibilities, auditor skills, reassignment of staff to support tax return processing, and staff vacancies have all impacted the department's ability to maximize the use and efforts of its compliance staff.

The department is taking steps to strengthen and reemphasize the audit function for individual income and natural resource taxes. These tax areas have been impacted by staff turnover and technology changes. The corporate license tax area has been less impacted by these conditions. Examples of staffing-related concerns include:

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- ▶ **Hiring and retention – vacant auditor positions.** As of April 2006, the following audit positions were vacant: 4 of 14 individual income tax field auditors, 4 of 10 natural resource auditors (either vacant or diverted to other functions), and 3 of 33 individual income desk auditors. A pay exception has been implemented for certain audit positions and there does not appear to be as many problems hiring new staff. However, there has not been any analysis done by the department to determine if the pay exception is having any longer-term benefits for staff retention.
- ▶ **Staff responsibilities are changing.** One area of concern for audit managers is how to integrate all staff into emerging audit activities based on the implementation of new technology capabilities in the IRIS tax processing system. Computerized processing is reducing the need to complete certain activities previously done by audit staff. Different staff capabilities may be needed as audit focus changes. The department needs to finalize a plan for providing additional training for up to 40 percent of its workforce in individual income tax audit to maximize their benefits to the organization.
- ▶ **Audit staff are shifted from compliance activities to assist in addressing items identified during the posting of tax returns.** The amount of work involved in processing taxpayer returns has resulted in the department diverting staff from compliance audit functions to assist with return posting. For the current processing season, 23 audit staff were shifted to assist with clearing returns. Department management realized this is not the most effective use of compliance audit staff and anticipate resolving this issue prior to the 2007 tax-processing season. E-filing could relieve some of the processing workload in the future.
- ▶ **The department has undergone significant changes.** Since 1998, numerous reorganizations and the development and replacement of a centralized computer system have affected staff resources available to conduct the department's audit functions. Experienced staff were reassigned from audit functions to assist with efforts to implement the POINTS system and its replacement, IRIS. Legislative testimony stated POINTS implementation efforts cost the department \$25 million in lost audit revenues. Personnel turnover also impacted the experience base of the audit units and reduced the ability of the department to conduct more sophisticated audits or conduct the same

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number of audits it had in the past. These conditions resulted in a de-emphasis of the audit function

The Division Needs to Conduct a Staff Analysis to Maximize Audit Capabilities

By not maximizing use of staff resources, the division's ability to perform compliance audits has been impacted. As discussed earlier, studies of federal tax compliance efforts found audits have a statistically significant impact on taxpayer compliance. As audit functions and emphasis evolves, skill sets and staffing levels may change. Department management has not completed a staffing analysis to respond to the changes in staff responsibilities within the three tax units.

This staffing analysis will serve as a framework to ensure staff have the knowledge, skills and abilities to perform the audit work associated with each tax unit as new responsibilities emerge; identify training opportunities to enhance employee skills; identify areas where staff specialization could improve specific skills; and, make staff assignments that are appropriate for skills needed - putting the right people in the right jobs. A staffing analysis will also identify and justify future staffing needs.

Recommendation #5

We recommend the Department of Revenue conduct an analysis of existing staff capabilities to maximize resource allocation among audit functions and ensure staff skills and competencies align with Business and Income Taxes Division responsibilities.

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Use Data Matching to Enhance Audit Operations

The IRS and other states successfully use data from other governmental sources to identify unreported income, underreported income and nonfilers. In fact, research regarding IRS enforcement actions found automated record cross-matching activities have the greatest indirect yield relative to cost. Other states' tax agencies also use data from other governmental sources to help identify noncompliance. The following table provides examples.

Table 4

Information Sources to Detect Taxpayer Noncompliance

Type of Information	Can be Used to Identify	
	Unreported Income	Nonfilers
Internal Revenue Service	X	X
Motor vehicle registration		X
Drivers' licenses		X
Hunting and fishing licenses		X
Withholding	X	X
Incorporation or business licenses	X	X
Professional and occupational licenses	X	X
Lottery and other gambling	X	
Property sales	X	X
Unemployment insurance	X	X
Motor fuels	X	X
Right of Way Sales	X	X
Government vendors and suppliers	X	X

Source: Compiled by the Legislative Audit Division from Internal Revenue Service and other states.

DOR recognizes the importance of information sharing and established the following objective in the department's 2007 Biennium Goals and Objectives. "Improve the exchange of information on a mutually beneficial basis with other state agencies, while maintaining the confidentiality requirements of state and federal law." However, there are barriers to effectively using other agency information.

DOR Could More Effectively Use Government Source Data

While the department currently uses some data sources to identify noncompliant taxpayers, it could be more effective in its efforts. The

Chapter V – Strengthening the Compliance Audit Function

department does not fully use data from the IRS and various state agencies to identify unreported income, underreported income, or non-filers. There are other sources of information that could be beneficial to the department's audit efforts. Specifically, we found:

- ▶ Limited cross matching of tax records to records maintained by various state agencies such as Administration; Fish, Wildlife and Parks; Labor and Industry; Justice; Transportation; Natural Resources and Conservation; Public Health and Human Services, and Secretary of State. The department is working to establish Memorandums of Understanding with other state agencies.
- ▶ Tax information available from the IRS is not used to its fullest extent as part of DOR's compliance audit function.
- ▶ Much of the cross matching done with other state agency records involves audit staff manually querying data on a record-by-record basis as opposed to having access to "bulk" electronic data and using electronic data mining tools.

In addition, the department's data cross matching efforts are not always performed in an efficient manner. We found large portions of W-2 forms are submitted to the department in paper rather than electronic format. Staff must hand-enter data from W-2s submitted in paper form in order to cross match this data to tax returns. Form 1099 (reports income from interest, proceeds from real estate transactions, etc.) is another example of paper-based records that audit staff must hand-enter when cross matching is done. Also, records provided by other state agencies do not always contain a taxpayer identification number; this restricts DOR's cross matching efforts.

Several Factors Reduce DOR's Ability to Identify Noncompliance

There are three factors that contribute to the department's limited data matching efforts. First better communications between department staff could more effectively identify cross-match information needs, availability, and barriers preventing access. This could make the department's efforts at identifying noncompliant taxpayers more efficient. Compliance audit staff are not fully aware of IRIS system capabilities and how the system could be used to more effectively identify noncompliant taxpayers through automated data mining techniques. Information services staff is not fully aware

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of data matching needs of the audit function and thus cannot explore options to assist audit in its efforts to identify noncompliance taxpayers. Lastly, department legal staff have not been briefed on what data the audit function would like to have access to so they can address legal issues that prevent DOR from accessing other agency data or from accessing taxpayer identification data maintained by other agencies, such as getting taxpayer identification numbers from fishing and hunting licenses to identify residency.

The second factor is limited data from the IRS and no data from other state agencies have been integrated into the data management module of IRIS; thus data cross matching is not being done within the system. The IRIS software came with this module and it's similar to a data warehouse. The department's efforts with IRIS have focused on implementing the system and getting all tax types phased onto the new system; thus staff have not had time yet to explore the system's auditing capabilities. IRIS has more sophisticated capabilities than past systems. The new system will more readily interact with IRS databases and should have capabilities to interact with other state databases. Now that the implementation phase will be complete in December 2006, the department should be able to work on using IRIS capabilities to warehouse data from other sources and use data extraction tools (electronic data mining software) to cross match data.

Third, the department's data cross matching efforts are hampered by limited requirements to report income-related information to DOR in a format that allows for efficient cross matching of records. Large numbers of W-2 and 1099 forms are submitted to the department in paper rather than electronic format which forces audit staff to hand-enter data. Department staff stated they currently have thousands of documents to be hand sorted and processed for compliance work on individual income tax.

Electronic Reporting of Data

As a result of these issues, the department is not as effective as it could be at identifying noncompliant taxpayers. Accurately identifying returns that are likely to be noncompliant or potential

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nonfilers would help the department ensure its limited resources are effectively targeted at compliance problems. Hand-entry of data from W-2s and 1099s is an inefficient use of staff resources given the amount of time it takes to input the data. However, not entering the data significantly reduces the department's ability to identify taxpayer noncompliance.

Other states have increased use of electronic data filing. For example, Minnesota requires electronic filing of sales and use tax returns and is seeking legislation to require employers to submit state withholding data in a common electronic format. Until electronic data filing of income and withholding information becomes the standard, DOR will have to do manual entry of this information in order to perform compliance activities.

DOR Can More Effectively Use Data to Identify Noncompliance

The department could enhance its abilities to more effectively use data from various sources to identify noncompliance. Issues that need to be addressed include the need for coordinated efforts between divisions to determine audit function's data needs, identify most effective and efficient data matching techniques, and resolve current barriers to accessing and using data. In addition, the department needs to identify tactics necessary to increase the use of electronic data filing by taxpayers and migrate towards more electronic tax information.

Recommendation #6

We recommend the Department of Revenue:

- A. Create an internal working group consisting of members from audit, legal, and information technology services to identify information needs, determine current barriers to obtaining data, and undertake necessary steps to obtain needed data.**
- B. Expedite integration of data from the IRS and other state government agencies into the data manager module within IRIS.**
- C. Seek Memorandums of Understanding and statutory authorization to access data maintained by other state agencies to include taxpayer or business identification number.**
- D. Enact necessary changes to increase electronic filing of income and withholding information.**

Department Response



Dan Bucks
Director

Montana Department of Revenue



Brian Schweitzer
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June 12, 2006

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JUN 12 2006
LEGISLATIVE AUDIT DIV.

Subject: Performance Audit - Improving Taxpayer Compliance in Montana

Dear Mr. Seacat:

Thank you for the opportunity to provide the Department of Revenue's (department) response to the audit recommendations contained in your report. The department's responses to the audit recommendations are as follows.

Recommendation #1:

We recommend the Department of Revenue:

A. Complete strategic planning for its audit activities to focus efforts on reducing taxpayer noncompliance.

Concur: The department will complete a strategic planning process by the end of calendar year 2006 and will update it on a biennial basis. This strategic plan will have as an overarching goal measuring and reducing the Montana tax compliance gap. Within the context of that overall goal, the plan will implement these five priorities:

- **Prevention:** Audit and other compliance coverage needs to be sufficient for each tax type and for major taxpayer groups.
- **Taxpayer Education and Convenience:** Complying with state taxes should be as convenient and understandable as possible.
- **Fairness:** Differences in filing and reporting rates among taxpayer groups need to be minimized to maintain public trust in the fairness of the tax system.

- **Productivity:** Except as necessary to achieve the four other compliance priorities, compliance efforts should yield the highest return on investments measured over reasonable periods of time.
- **Emerging Issues:** Compliance efforts should be flexible and dynamic enough to discover, investigate and respond to changing patterns of noncompliance.

If the state is to reduce the tax gap, the department needs significant additional resources and improved laws. The department has requested what it believes are necessary statutory changes as part of the Executive Planning Process. The department has also requested a significant increase in audit resources. The 2007 Legislature has important choices to make about the level of noncompliance that will be tolerated in Montana's tax system. Once the legislature makes those choices the department has the ongoing responsibility to adjust its strategic plan to most effectively make use of the laws and resources available.

B. Establish priorities for achieving audit goals and objectives.

Concur: Once the department has finalized the strategic plan discussed above, the department will list the appropriate audit goals and objectives that will be developed for existing and new audit initiatives.

C. Expedite completion of the Business and Income Taxes Division compliance plan.

Concur: The division has developed a new draft compliance plan that addresses known areas of taxpayer noncompliance. Once the department has completed review of the current compliance work being conducted, newly identified areas of noncompliance will be targeted and added to the division's compliance plan in coordination with the overall department strategic planning process.

Recommendation #2:

We recommend the Department of Revenue:

A. Identify performance goals for existing and future compliance audit activities in the areas of productivity, duration, and intended effect.

Concur: The department has established revenue goals for its current compliance work. This includes existing programs and new initiatives associated with the 2005 compliance decision package. Once the department has completed the initial investigation of the new compliance initiatives, all performance goals for existing and future audit activities will be reviewed and developed where possible. It is expected that the initial review and establishment of performance goals associated with new and existing compliance initiatives will be conducted in conjunction with the strategic planning process to be completed by the end of calendar year 2006.

B. Identify and collect performance data for each audit activity for comparison with performance goals.

Concur: The department does collect performance data for audit programs, most of which is manually captured and tracked. The department also collects specific performance data for our new compliance initiatives, which is also a manual process. The department has designed an automated performance tracking system to be implemented by July 2007. The automated tracking system will allow the department to effectively identify and collect performance data, not only by audit program, but also by compliance initiative.

Recommendation #3:

We recommend the Department of Revenue:

A. Conduct tax gap analyses that specifically measure compliance with Montana's tax laws at intervals that, at a minimum, correspond with strategic planning cycles in order to recognize a need to make corrections to compliance activities.

Concur: A tax gap study is crucial for a tax agency to truly determine areas of noncompliance and to effectively identify methods to address those areas. The department will be asking the 2007 Legislature to fund a Montana specific tax gap study. In the past, the department has conducted tax gap studies based solely on the Internal Revenue Service's (IRS) tax gap studies. While the IRS's tax gap studies are useful in developing a Montana study and provide general guidance to problem areas with income taxes, the tax gap analysis falls far short in identifying areas of concern with Montana's tax law. Current tax gap studies do not adequately address compliance issues with respect to non-residents or out-of-state companies and other tax types, such as combined oil and gas production tax. The department looks forward to working with the 2007 Legislature in fully funding a tax gap study to address this recommendation.

B. Report the results of tax gap estimates to the Legislature with recommendations to address the tax gap.

Concur: A comprehensive tax gap study will logically lead to reallocation of resources within the department and recommendations to the Governor and legislature for changes in resources and statutes.

Recommendation #4:

We recommend the Department of Revenue:

- A. More effectively deploy audit resources by directing audit activities to focus on the following factors to achieve the greatest benefit:**
- **Areas of greatest taxpayer noncompliance as identified in the tax gap.**
 - **Opportunity to generate the highest net returns.**
 - **Areas with the strongest legal enforcement and collection tools.**
 - **Opportunity to reduce inequities in filing rates among major tax filing groups.**
 - **Opportunities to provide staff training.**

Concur: As stated earlier, the department agrees that audit resources, closing identified tax gaps, and continued development of performance measures are all necessary to effectively manage Montana's tax system. The department also concurs that the five factors identified in this recommendation are important, but not exclusive, considerations for managing tax compliance. The department has outlined what it considers to be major compliance goals and priorities in its response to Recommendation #1. The department will continue to use all of its resources to effectively manage Montana's tax system, but without the assistance of the legislature, the department will not be able to fully address all of the issues identified in this performance audit and response.

- B. Conduct an analysis of the department's existing legal, enforcement, and collection tools to improve the department's ability to secure tax compliance from nonresidents.**

Concur: The department has reviewed our ability to secure tax compliance from nonresidents. Once again, the department will be asking the 2007 Legislature to partner with us to develop strong enforcement laws and provide adequate funding to pursue nonresidents who choose to ignore Montana tax law.

Recommendation #5:

We recommend the Department of Revenue conduct an analysis of existing staff capabilities to maximize resource allocation among audit functions and ensure staff skills and competencies align with Business and Income Taxes Division responsibilities.

Concur: The department's business processes have been evolving with the implementation of Integrated Revenue Information System (IRIS). The department will review, adjust, and improve our staffing levels as well as assess staff expertise. When these types of improvements are identified the department will provide existing staff with the necessary training to conduct new duties, hire new staff with the required skills, and reallocate department staff as necessary. This review will allow the department to align the current business processes and compliance initiatives with current compliance needs. The review will be ongoing and addressed through vacant positions and available training opportunities. In order to accomplish these goals, the department will require appropriate funding from the legislature.

Recommendation #6:

We recommend the Department of Revenue:

- A. Create an internal working group consisting of members from audit, legal, and information technology services to identify information needs, determine current barriers to obtaining data, and undertake necessary steps to obtain needed data.**

Concur: Although the department has implemented several working groups that discuss the areas identified in this recommendation, a review of how this recommendation can be implemented for all compliance responsibilities will be undertaken. The review will be complete by the end of calendar year 2006.

- B. Expedite integration of data from the IRS and other state government agencies into the data manager module within IRIS.**

Concur: The department is working diligently in implementing the full functionality of IRIS. The department's current IRIS focus is the implementation of the remaining tax types into IRIS and the shut down of POINTS. The legislature has mandated that this last phase of the project be complete by the end of calendar year 2006. The department will continue throughout the year to implement as much of the functionality, including the data manager, as soon possible without jeopardizing the completion dates of the final phase of the project and the shut down of POINTS.

- C. Seek Memorandums of Understanding and statutory authorization to access data maintained by other state agencies to include taxpayer or business identification number.**

Concur: The department has been aggressively implementing Memorandums of Understanding (MOU) with other state agencies in order to share information so all agencies can effectively enforce Montana's laws. Currently, the department has an information sharing MOU with the Department of Fish, Wildlife and Parks, the Department of Public Health and Human Services, and the Legislative Fiscal Division. The department will enter into information sharing MOUs with all other agencies with

which it currently has or may in the future be exchanging information. The department is also reviewing current information exchange statutes to determine changes that may be beneficial in assisting with the enforcement of tax laws. Upon conclusion of the review the department will bring any recommendations for amending or expanding information sharing opportunities to the legislature.

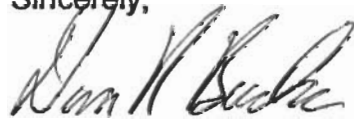
D. Enact necessary changes to increase electronic filing of income and withholding information.

Concur: The department recognizes that electronic filing provides benefits in tax processing administration and compliance with tax laws. To increase electronic filing will require significant appropriations and where appropriate statute changes. Since the department cannot enact any law or appropriation, it will have several proposals for electronic filing and is eager to work with the upcoming legislature to implement these proposals.

We appreciate you and the other members of the staff for the time you spent working with us during the audit. I specifically want to thank Lisa Blanford and Steve Erb for their professionalism in conducting the audit and their careful attention to the tax compliance needs of the State of Montana.

Again, thank you for the opportunity to respond to your recommendations. Please contact me if you have any questions or need clarification of any of the above items.

Sincerely,

A handwritten signature in black ink, appearing to read "Dan W. Bucks", written over a horizontal line.

Dan Bucks
Director